

Vietnam's Economic Prospects and Challenges¹

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Before the world recession hit, Vietnam was one of the world's fastest growing economies. Between 1995 and 2005, Vietnam's real GDP grew at an average rate of 7.3% a year. The economy successfully weathered shocks from SARS, avian influenza, bad weather, high commodity prices and anti-dumping suits. Per capita income soared by more than 6% a year, rising from \$260 in 1995 to \$835 in 2007. This strong growth record raised hopes that Vietnam could soon join the ranks of middle-income countries.

Economic growth in Vietnam over this period led to remarkable success in reducing the incidence of poverty. The poverty rate fell from 58% of the population in 1993 to 16% in 2006. Over the same period, the distribution of income became more unequal, but only slightly more so. The incidence of poverty remained high among ethnic minorities living in isolated areas.

Economic reform and dramatically increasing integration with the global economy underlie Vietnam's economic rise. Recent economic growth has been driven by the private sector, which has come to represent more than 50% of the manufacturing sector. While the government remained unwilling to privatize state-owned enterprises, many new private firms were registered, including 59,000 in 2007 alone. Exports (of garments, footwear, wood products, rice, fish and other items) grew massively – faster than in other Asian countries. Foreign investment, once forbidden by the Communist regime but now attracted by Vietnam's low-cost but productive labor force, became buoyant. The overall rate of investment was very high – 40% of GDP in 2007. Vietnam's integration with the world economy was capped by its accession to the World Trade Organization in January 2007. The United States became Vietnam's second largest export market after China.

The economy's growing openness and export orientation, however, left it vulnerable to the recent world recession. After registering GDP growth at 8.5% in 2007, the third straight year in which growth exceeded the government's 8% benchmark, growth of the Vietnamese economy slowed to 6.2% in 2008. The decline bottomed out in the first quarter of 2009 and growth has begun to pick up since then. Although the IMF earlier foresaw economic growth of about 3.5% this year, the World Bank recently predicted a year-on-year increase of 5.5%.

A good year for agriculture and an aggressive stimulus program have done a lot to blunt the effect of the world recession and help to maintain a positive growth rate. Important fiscal elements of the government's stimulus program were increased public development expenditures, exemptions and deferrals of tax payments for enterprises and deferred payment of personal income taxes. The government also tried to accelerate the mobilization and disbursement of foreign aid funds, especially for infrastructure projects and other projects that would promote exports and job creation. The State Bank of Vietnam (the central bank) dramatically loosened monetary policy between mid-2008 and early 2009, cutting its main

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interest rate, the prime rate, from 14% to 7%. It also provided interest rate subsidies on bank lending to businesses. Since the subsidies were introduced in February, Vietnam's commercial banks have lent out around \$22.5 billion. Fearing over-expansion of credit, the SBV told state-owned and private equitized commercial banks in July to limit their credit growth to 25-27% this year.

Economic growth is expected to accelerate in 2010 and 2011 but not reach the phenomenal rates recorded in the pre-recession years. Growth rates in the range of 6-7% are expected. Manufacturing output is expected to increase in 2010 and 2011, despite continued slowness in the growth of manufactured exports.

While foreign investors remain optimistic about Vietnam's long-term growth prospects, investment in manufacturing is likely to lag over the next two years. Capacity utilization rates in manufacturing are low at present and there has been a build-up of inventories this year.

Despite its favorable effect on economic growth, the government's stimulus program risks destabilizing the economy. Since the promulgation of a State Budget Law in 2004, management of government finances has improved significantly. Yet there is still a lot of off-budget expenditure and the policy makers have consciously opted for supporting economic growth over maintaining economic stability, running large budget deficits, and planning to extend the stimulus program into 2010. Details have not yet been released, but the government apparently intends to continue the interest rate subsidy program in 2010, despite being urged by the World Bank and IMF to phase it out. It has indicated, however, that the four percentage point subsidy that it currently provides for qualifying commercial loans will be reduced to two percentage points while in addition short-term loans will cease to be eligible for the program after the first quarter of 2010.

There is concern that continued stimulation of the economy will bring about accelerated inflation. The interest rate subsidy has proven to be an effective way of providing firms with working capital, but it has been accompanied by a surge of domestic credit that could threaten price stability. Although consumer price inflation has slowed sharply of late and is currently running at only 3% a year, Vietnam has experienced considerable inflation in the past and could be risking a return to double-digit price increases through overly expansive monetary and fiscal policies. Food and foodstuffs carry a 40% weight in the consumer price index, so rising prices for these goods can have a major impact on the overall price level. The IMF and the Asian Development Bank (ADB) have already called on authorities to tighten monetary policy and curtail credit growth. The SBV is expected to raise interest rates in 2010, perhaps by as much as two percentage points.

A wide trade deficit persists and is causing concern. Weakness in overseas markets caused Vietnam's merchandise exports to fall 13.8% year-on-year to \$46.3 billion in the first ten months of 2009. In the same period, the value of imports fell by 21.7% to \$55.1 billion. Thus, even though imports fell faster than exports the trade gap remains wide.

There is also concern about the level of foreign exchange reserves. Although the government has insisted that reserves are adequate, it plans to augment its level through borrowing from the

World Bank, Japan and the ADB. At some point, however, it may be forced to reduce its emphasis on economic growth in favor of economic stability, a shift that could prove unpopular and politically difficult.

Many of Vietnam's most important exports are performing poorly in 2009. Garment exports are down while exports of shoes have declined sharply. Relatively weak demand for Vietnamese goods abroad has discouraged firms from investing in capital equipment and purchasing inputs to be used to produce exports.

The government is running a large budget deficit and is seeking more outside funding. The Economist Intelligence Unit (EIU) expects the budget deficit (excluding on-lending) to rise to 9% of GDP in 2009 and remain at around 8% in 2010 and 2011. Revenues are expected to improve as economic growth picks up, but expenditure is likely to remain high as the government spends heavily on measures to revive the economy and improve social welfare programs. The government will continue to rely heavily on funds from international donors and has indicated its intention to tender a \$1 billion international bond issue in the near future.

The government of Vietnam has used successive dong devaluations to protect the balance of payments and maintain its export competitiveness. The 5% devaluation announced on November 25, 2009 was the third since June 2008. The move was motivated by increasing demand for dollars in recent months, which in turn was driven by concern over the widening trade deficit and inflationary expectations. This latest devaluation has worried rival Asian exporters, although their concern was limited by the smallness of Vietnam's economy and was much less acute than that felt over the undervaluation of China's currency. Despite these efforts to maintain competitiveness, Vietnam's exports are likely to rise only gradually as the slow recovery of the world economy boosts demand for Vietnamese goods in the next couple of years.

Foreign trade regulation remains an important issue. The European Union is considering whether to end anti-dumping tariffs imposed on Vietnamese and Chinese shoes in 2006. Doing so would give a much-needed boost to Vietnam's footwear industry, which has been hard hit by the global slump.

The ease of doing business in Vietnam is roughly average for developing countries.

Although the World Bank hailed Vietnam for cutting business taxes and easing foreign trade in 2008/2009, the country's ranking on the Bank's ease of doing business index fell slightly from 91st in 2009 to 93rd out of 144 countries in 2010. Particularly weak areas of the Vietnamese business environment are protecting investors (172nd), paying taxes (147th), closing a business (127th), and starting a business (116th). Stronger areas are getting credit (30th), enforcing contracts (32nd), and registering property (40th).

According to the IMF and World Bank, if Vietnam is to establish a modern economy and achieve middle-income status in the next few years (that is, lift GDP per capita to more than \$1,000), it must move ahead with a long list of reforms. These include:

- Implementing its WTO commitments;
- Reforming the banking system;

- Revitalizing the equitization (sale of stock shares) of large enterprises and state-owned banks;
- Establishing an efficient regulatory framework for infrastructure;
- Setting up social security systems covering health care finance, pensions, and unemployment benefits;
- Improving education;
- Protecting the environment and better managing natural resources;
- Establishing an efficient, accountable and transparent system of public administration; and
- Reducing corruption.

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